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International Trade: **Spotlight on Chinese Subsidies**

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As China's role on the international stage grows, its trade practices have attracted increased scrutiny from the international community.

In recent years, a number of complaints have been made to the World Trade Organization (WTO) concerning the Government of China's involvement in the marketplace and, in particular, the wide range of alleged subsidies — most of which are indirect — offered to domestic producers and exporters by the Government of China. Recently, these complaints have crystallized into the establishment of a WTO panel at the request of the United States and Mexico to examine the existence and impact of subsidies that are alleged to have unfairly boosted Chinese exports and skewed Chinese buying decisions to favour Chinese-made products.

Canadian businesses in the Chinese marketplace will want to follow these developments closely as the conditions of competition in Canada, in China and in other economies worldwide will be affected by the outcome of this proceeding. More importantly, Canadian companies producing or purchasing from China should also stay on top of the issues and developments. The Chinese government is viewing this complaint very seriously as it is anticipated that a decision in this case will provide clarification on the acceptable parameters of Chinese government funding.

Concerns About Regarding China's Adherence to WTO Obligations

The benefits of WTO membership are coupled with obligations to the international trading community. All WTO countries have agreed to abide by international agreements that establish ground rules for trade. Under these agreements, all WTO countries must provide non-discriminatory treatment, eliminate dual-pricing practices and ensure that price controls are not used to safeguard domestic industries. As the strength of China's economy becomes apparent, other WTO members are questioning whether China is living up to its WTO promises.

Overview of Subsidies Provided by the Chinese Government

The subsidies offered by the Chinese government that are at the heart of this dispute are the subject of controversy because they are believed to encourage Chinese exports and favour the use of Chinese over imported goods. Chinese enterprises with some foreign investment are offered refunds, reductions or exemptions from taxes or other payments due to the Chinese government.

Chinese subsidy programs have been characterized as "horizontal", meaning that they are applied to a wide range of manufacturing sectors. These subsidies are alleged to influence

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the conditions of competition between goods and provide Chinese businesses with an advantage over their international competitors. Canadian companies have expressed concerns about their ability to compete with subsidized goods.

The U.S. and Mexico argue that Chinese subsidies, although granted domestically, have a wide-ranging impact on markets across the globe. They say that the subsidies that increase the capacity of Chinese producers to export, enable them to offer lower prices and thereby gain a greater market share in foreign economies. They allege that, at the same time, subsidies provide a protectionist barrier to entry into the Chinese market, hindering the ability of foreign exporters to compete in that particular market. They say that the end result of these measures is that the goods produced by China are positioned advantageously in comparison to foreign goods, rendering competition between the Chinese and the imported goods inequitable.

China has expressly rejected the allegations that it provides subsidies contrary to its international obligations. At an October 25 meeting of the WTO's subsidies committee, China stated that it has endeavoured to comply with its 2001 WTO accession commitments. It contended that the success of its industries were not a result of subsidies; instead, these successes resulted from the country's comparative advantage in production costs.

Dispute Settlement at the WTO

When a WTO member provides subsidies that, in the view of another WTO member, are contrary to international obligations, recourse is made to the WTO's dispute settlement system. First, a complaining WTO member engages in consultations with the allegedly non-compliant member. If the issue is not resolved through these initial consultations, the complainant can ask the dispute settlement body (DSB) to establish a panel. The panel, which consists of three to five experts chosen in consultation with the parties to the dispute, examines the complaint. Within roughly six months' time (or sometimes longer depending on the complexity of the legal issues), the panel will produce a report containing its findings and recommendations. Any party to the dispute can appeal the panel's decision to the WTO Appellate Body. The DSB adopts the panel's report within 60 days after it is issued, or in the case of an appeal, the DSB adopts the Appellate Body's report within 30 days of its issuance. Thirty days after the adoption of the panel or Appellate Body's report, the offending party must inform the DSB of its intentions to implement the recommendations. If it is impracticable to comply immediately, the member must comply within a "reasonable period of time".

WTO Panel to Examine Chinese Subsidy Programs

On February 2, 2007, the U.S. requested consultations with China concerning certain subsidies provided by the Government of China. In the view of the U.S., China's subsidies are inconsistent with Article 3 of the *Subsidies and Countervailing Measures Agreement* (SCM) in that they provide refunds, reductions or exemptions from taxes and other payments owed to the government by enterprises in China on the condition that those enterprises purchase domestic over imported goods or on the condition that those enterprises meet certain export performance criteria. The U.S. also claims that China's favourable treatment of domestic goods contravenes Article III:4 of the *General Agreement on Tariffs and Trade* (GATT) and Article 2 of the *Trade-Related Investment Measures Agreement* (TRIMs). Furthermore, the U.S. alleges that China's actions are not in compliance with Part I of its

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Accession Protocol, which forms part of the terms of accession between China and the WTO and is an integral part of the *Marrakesh Agreement Establishing the World Trade Organization*. The U.S. government asserts that the measures implemented by the Government of China nullify or impair the benefits that are supposed to accrue to other WTO countries under the agreements mentioned above.

A number of countries joined in the consultations with China, including Canada, the European Communities, Australia, Japan and Mexico. Following certain amendments by China to its income tax legislation, supplementary consultations were requested; however, these were unable to successfully resolve the disputed issues.

On August 31, 2007, at the request of the U.S. and Mexico, the WTO set up a panel to examine China's subsidy programs. The Government of Canada, as a third party in the proceeding, has the right to be heard by the panel and make written submissions.

China's Obligations Under the Accession Agreement

At the heart of this WTO dispute is the question of whether China is violating the obligations it signed onto when it joined the WTO in December 2001. Under the Protocol of *Accession of the People's Republic of China*, China officially became a member of the WTO. As a member of the WTO, China adopted and agreed to implement the WTO's multilateral trade agreements, including the SCM, GATT, and TRIMs. The panel will investigate China's compliance with the Accession Agreement by determining whether it has upheld its part of the bargain in implementing these agreements under domestic law.

Obligations Under Article III:4 of the GATT

When China joined the WTO in 2001, it agreed to comply with the GATT, including provisions requiring countries to maintain a level playing field for domestic and imported goods.

Article III:4 of the GATT specifies that contracting countries must provide national treatment. Essentially, this means that imported goods must be treated no less favourably than domestically-produced goods in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. The U.S. and Mexico argue that the provision of subsidies by the Government of China afford favourable treatment to Chinese industries to the detriment of foreign competitors.

Obligations Under the TRIMs Agreement

The TRIMs Agreement recognizes that certain investment measures restrict and distort trade. As a result, the agreement stipulates that no contracting party shall apply any TRIM that is inconsistent with Articles III (national treatment) and Article XI (prohibition of quantitative restrictions) of the GATT. Appended to the agreement is a list of prohibited measures. Measures that require enterprises to procure a certain percentage of goods locally ("local content requirements") and measures that restrict the volume or value of imports that an enterprise can purchase or use to an amount related to the level of products it exports ("trade balancing requirements") are expressly prohibited. The agreement calls for the elimination of these measures. The U.S. and Mexico argue that certain Chinese taxes, refunds and other payments that stimulate Chinese exports and cause buyers to choose Chinese products violate the TRIMs Agreement.

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Obligations Under the SCM Agreement

The SCM Agreement places certain restrictions on the ability of WTO members to provide subsidies that give an unfair trade advantage to certain corporations or industries within its borders. The SCM Agreement addresses subsidies that are available only to an enterprise or industry, or group of enterprises or industries within the jurisdiction of the authority granting the subsidy. Subsidies fall into one of two categories under the SCM; a specific subsidy is either actionable or prohibited.

Actionable subsidies are subsidies that have an adverse effect on another WTO member. Subsidies that cause "serious prejudice" to the interests of another WTO member by causing them to lose market share in a third country market are one example of actionable subsidies.

WTO members are prohibited from offering subsidies contingent on export performance. They are also prohibited from offering subsidies that are dependent on the use of domestic over imported goods. If a subsidy is prohibited, the WTO requires that it be discontinued.

The U.S. and Mexico, in their complaints to the WTO, allege that China provides a number of industry-specific prohibited and actionable subsidies that are inconsistent with China's international obligations. Among these are subsidies that provide tax incentives to enterprises that purchase domestic rather than imported equipment for use in their operations and subsidies that provide tax credits to enterprises based on their level of foreign investment and expansion into foreign markets.

In requesting a WTO panel, the complainants are seeking a finding of WTO inconsistency that will cause the Government of China to terminate these subsidization programs. The panel's conclusions and recommendations in this regard are expected to be released in 2008.

The Importance of this Dispute to Businesses Engaged in Trade

In response to foreign trade-related criticisms, the Chinese government has initiated a number of policies in an effort to "even" the playing field. They include:

revamping its enterprise income tax to phase out favourable treatment to foreign-invested enterprises; and

tightening administration in a number of areas, including labour and intellectual property rights.

The Chinese government has also put in place policies to discourage investment in lower-end processing and in resource-consuming industries where the price of water and power are government controlled or "subsidized."

Nevertheless, the importance of this dispute to Canadian businesses cannot be overstated. China, which consistently ranks among the top export destinations for foreign businesses, represents a huge potential market for exports from abroad and a wealth of opportunities for foreign businesses who seek to establish operations in China.

For Canadian businesses, a WTO panel ruling that Chinese subsidies are WTO-inconsistent could result in significant market openings arising from changes to Chinese laws. For the

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Chinese government and Chinese business, a negative panel ruling could place severe constraints on Chinese funding programs and fiscal measures in support not only of Chinese companies but also of foreign companies based in China.

In consequence, any measures taken by the international community or, for that matter, the Chinese government, to reduce the competitiveness of its export industry could hurt foreign (Canadian) invested manufacturers as much as it hurts their Chinese-invested counterparts. Depending on which report one reads, foreign-invested enterprises account for between 55% to 65% of all exports from China. The implications are, therefore, apparent.

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